Yannis Stournaras: Exit from the crisis and return to economic growth

Speech by Mr Yannis Stournaras, Governor of the Bank of Greece, at the 82nd Annual Meeting of Shareholders, Athens, 26 February 2015.

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Agreement with our partners to avoid a stalling of recovery and to bolster growth

After six years of severe recession, the downturn in Greece came to an end in 2014, with economic activity resuming positive growth rates. This development, combined with the elimination of the high fiscal and current account deficits and with the implementation of significant reforms, arguably suggests that the necessary conditions are now in place for a definitive exit from the crisis and for accelerated growth in the immediate future.

However, this optimistic outlook has been clouded by a protracted period of uncertainty that peaked in recent weeks. The Eurogroup's decision on 20 February 2015 to grant Greece a loan extension and its approval on 24 February of the Greek government reform measures alleviate the uncertainty and give Greece's new government time to complete the reforms still pending and to set its own priorities. This is a positive outcome, as it averts a rift between us and our partners that would have had dire consequences for the Greek economy and beyond. In order to seize this window of opportunity, however, we must pursue the negotiations in a spirit of cooperation and trust and promptly conclude a mutually beneficial final agreement with our partners. At this crucial time, what is needed is a coordinated national effort, in close collaboration with European and international institutions, to ensure that the sacrifices made by Greek citizens will not have been in vain and to facilitate the economic restructuring needed for sustainable growth. The Bank of Greece stands ready to contribute to this effort with all of its resources.

Economic recovery in 2014 in a deflationary environment

2014 marked the return of economic activity to positive growth rates after six consecutive years of deep recession, during which GDP contracted by more than 25%. The available quarterly GDP data indicate that the recession has clearly been winding down since the first quarter of 2014, with year-on-year growth in 2014 returning to positive territory (0.8%) for the first time since 2007, driven by higher exports of goods and services and increased private consumption. More specifically, in the period from January to September 2014:

- ***Exports*** increased by 8.4%, largely as a result of improved competitiveness, with a strong performance from tourism and shipping exports.
- ***Private consumption*** increased by 1.5%, on the back of stabilised real disposable income, a declining general level of prices and reduced uncertainty.

Other significant positive developments were ***the recovery of total employment by 0.3%*** and of dependent employment by 2.3%, while the number of unemployed decreased for the first time since 2008, by 3.3%. Nevertheless, the unemployment rate remains high and the highest in the EU. Another major concern is that the long-term unemployment rate continues to rise, which increases the risk of human capital depreciation.

Unit labour costs decreased further in 2014 on the back of higher productivity and lower employer contributions, thereby helping the economy gain in competitiveness. Structural competitiveness in Greece has been showing signs of improving since 2013. More specifically, according to the World Economic Forum's global competitiveness index, Greece moved up the ranking to 81st place, from 91st in 2012, while according to the World Bank's ranking on the "ease of doing business", Greece advanced to 61st place, from 65th and 89th, respectively, in the past two years. However, low access to financing, red tape and tax policy instability remain the biggest drags on the international competitiveness of Greek businesses.

The over-performance against the primary surplus target set in the Economic Adjustment Programme by 1.2% of GDP in 2013 was a milestone achievement that provides a solid base for the attainment of the fiscal target in 2014 for a third consecutive year. However, the general government fiscal outcome in 2014 faces downside risks, largely associated with the uncertainties in the last weeks of the year, combined with a back-loaded revenue schedule. These uncertainties have increased following the completion of the state budget execution for 2014, which pointed to significant tax revenue shortfalls, especially in December.

Despite an increase in public investment, total investment remains particularly low, reflecting a decrease in private investment mainly on account of limited bank lending and the high cost of borrowing. The fall in private investment was primarily concentrated in residential investment, whereas productive business investment has started to show signs of recovery. For the first time since 2008, the increase in investment in the third quarter of 2014, albeit moderate at 1%, may be signalling a longer-lasting recovery trend.

Global financial markets

Global financial market conditions continued to improve in the first half of 2014. Gradually, however, from the third quarter onwards, increasing investor uncertainty about the banking sector of euro area countries, signs of economic recovery losing momentum in the euro area and slackening growth in the global economy led to a surge in volatility in European capital markets.

Against this background and given country-specific factors weighing on the rating of Greek government bonds (mainly associated with uncertainties about political developments), Greek government bond yields once again spiked, returning to levels not seen since the third quarter of 2013.

Developments in the Greek corporate bond market were also negative in 2014. During most of the year, the yields on Greek corporate bonds moved broadly in line with the yields on bonds issued by European non-financial corporations, which have higher credit ratings. From the end of October, however, Greek corporate bond yield developments decoupled from those in European corporate bonds and followed the same sharp upward course as Greek government bond yields.

Developments in the Greek stock market were also negative in 2014, albeit not throughout the entire year. The prices of shares on the Athens Exchange dropped significantly, especially bank shares, although the results of the ECB's recent Comprehensive Assessment reconfirmed that the systemic Greek banks were adequately capitalised.

The Greek banking system remains strong despite the turbulence

The strengthening of banks' capital bases and operating profits before provisions, the first steps towards addressing the issue of non-performing loans and the activation, as of 4 November 2014, of the Single Supervisory Mechanism (SSM) were the main developments for the Greek banking system in 2014.

First, in early 2014, the Bank of Greece released the findings of its stress test of Greek banks. This, together with the downward trend of Greek government bond yields at the time, gave banks easier access to capital market funding. Towards the end of the year, the ECB completed its Comprehensive Assessment, which reconfirmed the capital adequacy of Greek systemic banks.

Despite these favourable developments, the banking system continues to face serious challenges, first and foremost the need to address non-performing loans (NPLs). The ratio of NPLs to total loans remained particularly high (September 2014: 34.2%, December 2013: 31.9%). On the upside, however, the pace of new NPL formation has slowed down markedly and the NPL coverage ratio from accumulated provisions has risen significantly.

Finally, the Single Supervisory Mechanism (SSM), which is the new banking supervision system composed of a supranational authority (the ECB) and the national competent authorities of the participating Member States, was activated on 4 November 2014. In order to ensure consistent supervisory practices and approaches, the ECB and the national authorities use a single rulebook, and a Joint Supervisory Team, formed of staff of the ECB and the national supervisors, is established for each significant bank. The ECB directly supervises some 120 significant banks, including Greece's four systemic banks. This direct supervision will involve examining banks' lending, borrowing and investment activities and overall compliance with European and national prudential regulation.

The decision by the ECB's Governing Council on 4 February 2015 (lifting the waiver of minimum credit rating requirements for marketable debt instruments issued or fully guaranteed by the Hellenic Republic) does not create liquidity problems for the Greek banking system: the banking system, now standing on sounder foundations after its recent consolidation, is well-capitalised and furthermore has access to liquidity, albeit at a much higher cost, from the Bank of Greece through the Emergency Liquidity Assistance (ELA) mechanism. This decision by the ECB's Governing Council will soon be re-examined and should be revoked, as in similar cases in the past, so long as Greece fulfils its recent agreement with its partners.

Positive outlook for 2015

Based on the latest available data, ***GDP growth is projected to be positive in 2015*** and to pick up in 2016. The main elements of uncertainty weighing on the prospects for economic activity in the medium term refer to our ability to fulfil the transitional agreement struck with our partners, a possible deterioration in public finances and reform fatigue.

If these uncertainties can be contained, then the economy can and should continue to recover in 2015, driven by exports of goods and services and by private consumption and supported also by rising business investment.

Exports of goods and services are expected to remain one of the growth drivers in 2015, with the global economic environment projected to improve as growth rates pick up both in the EU and the other markets and world trade strengthens. A positive impact is also expected from the further improvement in structural competitiveness and possibly in cost competitiveness, combined with restored access to financing for Greek businesses and an improving business climate.

Disposable income developments, the declining general level of prices and reduced uncertainty are expected to affect consumer spending positively in the course of 2015. Private consumption is therefore expected to increase in the year as a whole, supported by the fall in oil prices and the ensuing strengthening of Greek households' real disposable income.

The favourable outlook for investment should be supported by: (a) the deployment by domestic credit institutions and businesses of resources from the National Strategic Reference Framework (NSRF) and the utilisation of co-financing and guarantee instruments available from the European Investment Bank (EIB) and the National Fund of Entrepreneurship and Development (ETEAN); (b) further progress in major infrastructure projects – especially Greece's four main highways – and the potential of public-private partnerships, which have an immediate growth impact and can leverage investment capacity in the building materials industry and supporting services; (c) the Investment Plan for Europe jointly promoted by the European Commission and the EIB through the establishment of a new European Fund for Strategic Investments; and (d) the very accommodative stance of the single monetary policy which is expected to help improve financing conditions for sound businesses. A favourable impact will also come from the execution of projects under the Public Investment Programme with an overall budget of €6.4 billion for 2015.

Another factor that could considerably boost the investment climate is the completion of major privatisations. As the Bank of Greece has mentioned in the past, insofar as privatisations involve productive foreign direct investment, they can deliver a number of benefits for the privatised businesses, in terms of knowhow transfer, modernisation and efficiency, and for the economy as a whole by enhancing competitiveness and extroversion, as well as by helping to reduce the government's borrowing requirements and – ultimately – public debt in the medium term.

The recovery is still fragile and leaves no room for complacency

As mentioned above, the main uncertainties weighing on the prospects for economic activity in the medium term refer to our ability to bridge the time for discussions on an agreement with our partners, as well as to the onset of fiscal and structural reform fatigue. Signs of uncertainty are already visible in the economic sentiment indicators, which appear to have lost some of their upward momentum in late 2014 and early 2015, as well as in the budgetary slippages in December 2014 and January 2015. Lower-than-expected growth in the euro area and geopolitical risks are additional potential factors of uncertainty. On the other hand, the further decline in oil prices, the very accommodative stance of the ECB's monetary policy conducive to improved financing conditions, the prospect of a rebound of private investment once economic uncertainty dissipates, as well as the depreciation of the euro are expected to impact favourably on domestic economic activity.

Adoption of a national growth policy focused on reforms, for a definitive exit from the crisis and attainment of sustainable growth

Greece's positive macroeconomic performance in 2014 and optimistic prospects reflect the significant changes made in recent years with tangible benefits, but also serious negative side-effects. Key achievements include restored fiscal balance and the virtual elimination of the current account deficit, the latter reflecting a sharp contraction in domestic consumer and investment demand, but also an improvement in competitiveness. Also, headway was made with a number of structural reforms in the functioning of the State, while steps were taken to modernise the tax system and tax collection mechanism and broaden the tax base. On the downside however, these positive results have taken a heavy toll on the economy and society in terms of income, employment and human and physical capital.

These hard-won achievements must be preserved and consolidated, as they provide a cornerstone for the desired shift towards a new, export-led growth model. This is why it is imperative to quell uncertainties and ward off the risks that could cancel out the substantial progress made and undermine growth. The tremendous sacrifices made by the Greek people must not be in vain.

Amongst the crucial matters being debated at present are the ongoing negotiations with our partners and the securing of smooth financing conditions for the Greek economy as well as of unhindered bank funding.

One key area that will facilitate the conclusion of a final agreement is the advancement of the structural reforms still pending. ***These reforms are much smaller in scope and would entail low cost compared with the huge changes made in recent years at a very high price for Greek society***. Once these pending reforms are completed, there will be nothing but gains ahead for the economy. Needless to say, Greece would then have to implement its own programme of further reforms to solidify its basis for sustainable growth and social wellbeing.

If we, on our part, adhere to our commitments, our partners can in turn be expected to reiterate their decision, as explicitly stated at the Eurogroup meeting of 27 November 2012, to consider further measures to alleviate Greece's debt burden. This could be achieved by the methods envisaged in that Eurogroup statement or by other methods and would boost Greece's growth prospects, provided that economic policy stays committed to fiscal adjustment, primary surpluses and reforms to re-launch the economy. This would also allow the required primary surpluses to be gradually reduced, freeing up more resources for the financing of the economy. Let us not forget that such further measures to ensure a reduction of Greek public debt were, back in November 2012, made conditional to, and meant as a reward for, fiscal adjustment. This adjustment is now a reality.

Reaching a new agreement with our partners may be a necessary condition for the recovery to take root and gain traction. However, it is not an adequate condition for jump-starting the economy. At the present crucial juncture, what we need is a comprehensive and coherent growth plan geared towards strengthening the productive capacity through investment and, more importantly, through structural reforms.

The first practicable measures that would pave the way in this direction include:

(a) ***Completing the reforms already launched, pursuing structural reforms in the goods and services markets and developing a "smart economy".*** The further opening-up of closed professions, as well as of those goods and services markets that, according to OECD recommendations, still lack effective competition, must be speeded up. The privatisation strategy needs to give priority to accelerating the processes presently in course that, as mentioned previously, would help increase the efficiency of the companies being privatised, improve competitiveness, make the economy more export-oriented and – in the end – reduce public debt. Meanwhile, the available EU funding resources (under e.g. the NSRF, the Investment Plan for Europe) must be harnessed towards supporting knowledge and innovation and towards exploiting our comparative advantages in sectors of the "smart economy", including the culture and creative industries.

(b) ***Consolidating fiscal achievements.*** The fiscal achievements must be preserved and consolidated. Efforts must focus on structural measures to strengthen the independence and efficiency of tax administration, with the aim to tackle tax and contribution evasion. The application of modern, risk-based tax audit methods and the activation of a nationwide asset registry are fundamental in the fight against tax evasion.

(c) ***Reviewing tax exemptions and other favourable tax treatment***. Tax exemptions and favourable tax treatment, including reduced VAT rates, need to be reviewed and streamlined. Actions that could start immediately include the scrutiny, cost analysis and gradual abolition of the various exemptions from the general tax rules, unless they concern: (a) social groups hard hit by the crisis or living in conditions of poverty or (b) growth incentives providing much-needed stimulus to economic activity.

(d) ***Lowering tax rates and reviewing the efficiency of public spending***. To the extent that action under the preceding point is implemented, a lowering of the direct and indirect tax rates will become possible, with positive impact on growth without jeopardising fiscal sustainability. On the expenditure side, efforts to better target social benefits must continue, while the existing exemptions from the general pension system provisions must be re-examined. The strengthening of the financial framework for local governments needs to be completed, in order to curb the accumulation of arrears, while the newly established Independent Fiscal Council must assume an enhanced and effective role.

(e) ***Increasing public sector efficiency***. The remaining reforms in the public sector, mainly geared towards greater operational efficiency, transparency and equitability, must be taken forward. The generalised application of automated online procedures is an important means for improving the interaction of citizens and businesses with the State and can further serve as a backstop against corruption. Completing the national cadastre and eliminating the chronic obstacles to the efficient and speedy delivery of justice are fundamental prerequisites for a well-functioning state, as are the efficient deployment of human resources and a transparent staff appraisal framework that rewards productivity and work ethic.

(f) ***Strengthening active labour market policies and reducing the number of unemployed***. The absorption of the unemployed is expected to be a gradual process that will take time, given the current slack in the labour market. A de-escalation of unemployment – particularly amongst youth and the long-term unemployed – and a gradual recovery of the employment rate are expected to benefit, in addition to growth, from active employment policies, as programmes and actions financed by the NSRF 2014–2020 are phased in. Actions that promote employment, for instance through the development of local employment partnerships and vocational training programmes, will also be instrumental in tackling unemployment, especially its structural component. However, this strengthening of active policies needs to be combined with eligibility controls and results-based assessment of programmes and with a fight against undeclared and uninsured work.

(g) ***Effective management of non-performing loans (NPLs)***. The effective management of non-performing loans will have a positive knock-on effect on lending to sound businesses, given that banks' ability to extend new credit is closely linked with the smooth and timely repayment of existing loans. The NPL management model to be chosen must: (a) not give rise to moral hazard; and (b) enable the identification of the most appropriate workout solutions and, where possible, ease the burden on cooperating borrowers facing temporary difficulties in servicing their debt. Apart from effective NPL management, the consolidation of positive growth rates will obviously contribute significantly to improving the NPL recovery rate, by generating a self-reinforcing process of NPL reduction as the debt servicing capacity of households and businesses increases.

(h) ***Securing the smooth financing of the Greek economy***. The capacity of the banking system to finance the real economy does not depend on capital adequacy alone, but also on its liquidity. Following the recent capital increases, Greek banks have a sufficient capital base, but their liquidity has come under considerable strain, especially in the last few months. The stock of outstanding deposits is significantly lower today than it was before the crisis, plus the banks still have no access to money markets. After the recent decision by the ECB's Governing Council (4 February 2015) to exclude securities issued or guaranteed by the Hellenic Republic from the list of collateral acceptable for open market operations, the value of eligible securities held in Greek bank portfolios dropped significantly. Greek banks can still obtain liquidity from the Bank of Greece through the emergency liquidity assistance (ELA) mechanism, but, as entailed by the rules of the Eurosystem, at substantially higher cost. Hence, there is need for Greece to fulfil its recent agreement with our partners as soon as possible, so that this decision can soon be revoked.

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In the past few years, we have covered some very rough ground at high cost to the whole of Greek society. If we can address the relatively few issues still pending and complete the first phase of the effort launched in 2010, we will then be able to move on to the next phase, in which the growth potential of the economy will be considerably enhanced. Rapid growth will enable the implementation of more effective policies for restoring social cohesion which has been eroded by the crisis. The priorities of these

policies should be geared towards reducing unemployment and correcting inequality in the distribution of the burden from the adjustment effort. For this to happen, we must remain firmly committed to the country’s European course and fulfil the recently concluded agreement as soon as possible.